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SUBJECT: Environment a Top Priority at Guangdong-Hong Kong Leaders Meeting

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¶1. (SBU) Summary: Environmental issues were at the top of the agenda for new Party Secretary Wang Yang during his January 4 meeting with Hong Kong Chief Executive Donald Tsang, according to Peter Pak-yan Leung, Director of Hong Kong's Economic and Trade Office (ETO) in Guangzhou. Appreciating renminbi, rising costs, and government policies are making conditions more difficult for Hong Kong investors in the Pearl River Delta (PRD), but Leung expects most Hong Kong companies to stay, even as some expand in other parts of China. He is optimistic about future integration in the PRD, especially in financial services, but noted that Beijing, out of concern for regional economic disparities, was circumspect about any proposal that would offer additional economic advantage to the PRD. End summary.

Making Environmental Protection a Priority  
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¶2. (SBU) Wang told Tsang that his first month as Guangdong's Party Secretary had seen 20 days of "dirty" air, and he expressed

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dissatisfaction with the current level of environmental protection in Guangdong. HK ETO Director Leung believes that Wang is committed to improving environmental protection in the PRD during his tenure as Party Secretary. He called Wang's comments representative of the attitudes of many Guangdong provincial and local government officials who are working with Hong Kong to address environmental problems. Leung attributed this attitude in part to Chinese government policies that use environmental measures to rate the performance of local government officials in addition to growth and other economic measures.

¶3. (SBU) Leung said Hong Kong and Guangdong officials had agreed in a separate January 8 meeting to final emissions targets for sulfur dioxide and other air pollutants and planned for them to fully implemented by 2010. In addition, he noted that the Hong Kong Legislative Council was considering a bill to provide HK\$93 million (USD 12 million) to assist Hong Kong-owned factories in the Pearl River Delta increase energy efficiency and reduce emissions.

HK Factories Feeling Squeezed but Staying Put  
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¶4. (SBU) A combination of rising costs and government policies is

making it harder for Hong Kong companies in the Pearl River Delta to stay profitable, according to Leung. Hong Kong investment is heavily concentrated in the PRD, accounting for 80 per cent of Hong Kong's total investment in the mainland. Leung told us that 98,000 Hong Kong firms operate in Guangdong province, of which 60,000 are factories. The total value of Hong Kong private investment is approximately USD 120 billion.

15. (SBU) Leung estimated that the cost of production had been increasing by an annual rate of 20 percent in the Pearl River Delta due in large part to higher wages and energy costs. At the same time, appreciation of the renminbi makes the region's exports less competitive. Leung cited the new Labor Contract Law and government policies encouraging export processing industries to move up the value chain or inland from the PRD as challenges for Hong Kong investors.

16. (SBU) Some Hong Kong firms are now considering investing elsewhere as they expand in China. Many are looking north to locations like northern Guangdong, Hunan and Jiangxi provinces. Nevertheless, Leung emphasized that the PRD still offers Hong Kong investors considerable advantages and most firms will continue to use it as a manufacturing base. Even as some firms move labor-intensive operations elsewhere, he expects them to keep management and other headquarters functions in the PRD. He also pointed out that the advantage of cheap labor offered by places like Hunan and Jiangxi appears to be narrowing. Wages were as much as 40 percent cheaper in those locations in the past, but Leung said recent site visits and research suggested that the gap had narrowed to only 20 percent. In addition, transportation and other infrastructure are still much better in the PRD.

17. (SBU) Leung commented that the Chinese government was aware of the challenges facing Hong Kong investors and was making an effort to address their concerns. He described extensive opportunities for Hong Kong government and business leaders to submit comments on each

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draft of Beijing's new labor legislation, claiming that the final version was acceptable to most Hong Kong businesses.

Increasing Integration in the PRD  
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18. (SBU) Leung is optimistic about further cooperation and integration between Hong Kong and the rest of the PRD. He told us that Wang and Tsang had discussed the service sector, especially financial services, as a potential area of partnership. Leung said the Hong Kong SAR government might propose further opening of the financial services sector in Guangdong as a pilot program for the rest of China. However, he noted that Guangdong leaders were cautious about proceeding too far on such initiatives without clear guidance from Beijing. He explained that the central government in Beijing, out of concern for regional economic disparity, was circumspect about any proposal that would offer additional economic advantage to the PRD.

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